

Internal Revenue Service  
**memorandum**

CC:TL:Br2  
WCWicker

date: JUN 12 1987

to: Special Trial Attorney (International)  
Southwest Region

from: Director, Tax Litigation Division

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subject: [REDACTED]

This is in reply to your memorandum of March 9, 1987 requesting technical advice with respect to the issues stated below.

ISSUES

1. Because the recapitalization described below is tax motivated and lacks a significant business purpose, can it be disregarded and [REDACTED] ("[REDACTED]") treated as a target affiliate in a qualified stock purchase under section 338(d)? 1/

2. Should the newly created class of [REDACTED] preferred stock be treated as voting stock for purposes of section 338(d)(3)?

3. Is [REDACTED] ("[REDACTED]") an agent for [REDACTED] [REDACTED] ("[REDACTED]") in connection with the sale of the common and preferred stock of [REDACTED] to [REDACTED] ("[REDACTED]")?

SUMMARY

[REDACTED] was a target affiliate of [REDACTED] in connection with a qualified stock purchase of [REDACTED] stock. The [REDACTED] preferred stock issued to [REDACTED] pursuant to the recapitalization of [REDACTED] was not voting stock for purposes of section 338(d)(3). Conclusions with respect to the other issues enumerated above are deferred to a future technical advice memorandum, to be written and forwarded to you after our receipt of the additional data we have requested.

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1/ All section references are to the Internal Revenue Code of 1954, as amended and in effect for the tax period in question, and to the regulations thereunder.

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FACTS

In [REDACTED], [REDACTED] and [REDACTED] ("A") announced that an agreement had been reached for the acquisition of [REDACTED] by [REDACTED]. On [REDACTED], [REDACTED] purchased all of the stock of [REDACTED] and, thereafter, timely filed an election under section 338 to treat the stock purchase as an asset acquisition. [REDACTED] did not include [REDACTED] in its section 338 election as an [REDACTED] target affiliate for which an election is deemed made under section 338(f)(1). This failure to include [REDACTED] in the election is the subject of this memorandum.

[REDACTED] was incorporated under the laws of Nevada. Its name was originally [REDACTED] ("B"). [REDACTED] changed its name to [REDACTED] (that is, to [REDACTED]) shortly before and in connection with the [REDACTED] recapitalization described below. 2/

In [REDACTED] and up to [REDACTED], [REDACTED] owned all of the outstanding stock of [REDACTED], which consisted of [REDACTED] shares of common stock (par value of \$[REDACTED] per share). [REDACTED] engaged in the business of equipment leasing. Its principal place of business throughout most, if not all, of [REDACTED] was located at the same address in [REDACTED], Texas as the principal place of business of [REDACTED].

As of [REDACTED], [REDACTED] had claimed [REDACTED] of investment tax credit ("ITC") and depreciation deductions with respect to the equipment it leased to third parties. If [REDACTED] were to remain an [REDACTED]% owned and controlled subsidiary of [REDACTED] at the time of [REDACTED]'s purchase of all of [REDACTED]' stock, [REDACTED]'s subsequent election of section 338 would trigger recapture of substantial amounts of the ITC and depreciation that had been claimed by [REDACTED]. Because of this potential tax liability, the management of [REDACTED] authorized on [REDACTED], the sale of all of the [REDACTED] stock owned by [REDACTED] (which, as stated earlier, consisted of [REDACTED] shares of common stock, representing [REDACTED]% of the outstanding stock of [REDACTED]). The value of the [REDACTED] common stock, i.e., the net value of [REDACTED], was estimated to be \$[REDACTED].

[REDACTED] contacted [REDACTED] potential buyers in an effort to make an outright sale to a third party of its [REDACTED] common stock. It was unable, however, to come to terms with any of these parties within the required time frame, i.e., before the closing date of the [REDACTED] purchase of [REDACTED] stock. Being unable to make an outright sale of its [REDACTED] common stock, [REDACTED] entered into the following transaction with [REDACTED], a corporation unrelated to [REDACTED]. 3/

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2/ Hereafter, the term "[REDACTED]" will be used to refer to the corporation both during the period that it was named [REDACTED] and during the subsequent period that it was named [REDACTED].

3/ Like [REDACTED], [REDACTED] engaged in the leasing business.

The transaction with [REDACTED] involved a recapitalization of [REDACTED]. The recapitalization took place on [REDACTED]. On that date, pursuant to an agreement between [REDACTED], [REDACTED] and [REDACTED] styled "[REDACTED]" (the "Agreement"), [REDACTED] received, in exchange for surrendering to [REDACTED] all of its [REDACTED] common stock, [REDACTED] shares of a newly created class of [REDACTED] preferred stock. The preferred stock, denominated "Class A" preferred stock in the Agreement, had a par value of \$[REDACTED] per share and a stated value of \$[REDACTED] per share. In conjunction with exchanging its common stock for this preferred stock, [REDACTED] contributed \$[REDACTED] in cash to [REDACTED]. The cash contribution took place simultaneously with the common stock/preferred stock exchange and was intended to eliminate [REDACTED]' excess loss account respecting [REDACTED].

As part of the recapitalization plan and pursuant to the Agreement, [REDACTED] issued on [REDACTED], [REDACTED] shares of new common stock, par value of \$[REDACTED] per share, to [REDACTED] in exchange for \$[REDACTED] in cash paid to it by [REDACTED]. In conjunction with and on the same date as this common stock issuance, [REDACTED] contributed to the capital of [REDACTED] a promissory note in the face amount of \$[REDACTED]. The note, issued by [REDACTED] to the order of [REDACTED], was payable on demand or, if not sooner demanded, on [REDACTED]. The note bore interest at the rate of [REDACTED]% per annum; the interest, like the principal, was payable on demand. [REDACTED] could prepay the note at any time without penalty.

The rights and preferences of the [REDACTED] Class A preferred stock issued to [REDACTED] pursuant to the recapitalization were set forth in an amendment to [REDACTED]'s charter filed with the State of Nevada on [REDACTED]. Under [REDACTED]'s charter as so amended, the Class A preferred stock entitled its holders to cash dividends at an annual rate of \$[REDACTED] per share. The dividends were cumulative (in the event of a deficiency in payment thereof) and were payable quarterly on the [REDACTED] day of [REDACTED], [REDACTED], [REDACTED] and [REDACTED] of each year.

At any time after [REDACTED], the holders of Class A preferred stock had the right to cause [REDACTED] to redeem their stock at a price of \$[REDACTED] per share and, in connection with such redemption, to receive payment of any dividends accrued but unpaid to the time of redemption. At any time after [REDACTED], [REDACTED] had the right, exercisable by a resolution of its board of directors, to redeem all (but not part) of the Class A preferred stock at a price of \$[REDACTED] per share plus payment of accrued dividends. If the Class A preferred stock was not redeemed prior to a liquidation of [REDACTED], its holders would be entitled to receive out of the net assets of [REDACTED] (i.e., out of the assets remaining after payment of [REDACTED]'s debts) and before any distribution was made to [REDACTED]'s common shareholders, the amount of \$[REDACTED] for each share of preferred stock plus an amount equal to all dividends accrued and unpaid on each such share up to the date fixed for the liquidating distribution to the preferred shareholders.

Under the [REDACTED] charter amendment filed on [REDACTED], the holders of Class A preferred stock had limited voting rights. Up to and including [REDACTED], they had no right under any circumstance to vote for or to participate in the election of [REDACTED]'s directors. After [REDACTED], they would continue to have no right to vote for directors unless there existed or occurred dividend arrearages on their stock equal to at least two full quarterly dividends. If after [REDACTED], dividends on their stock were or became in arrears in an amount equal to or exceeding two full quarterly dividends, the holders of Class A preferred stock became entitled, for the duration of the "Class Voting Period," to (i) elect [REDACTED]% of the directors of [REDACTED] and (ii) in connection with any other matter to be acted upon by the shareholders of [REDACTED], to exercise voting power equivalent to [REDACTED]% of the voting power of the common shareholders. The Class Voting Period was the period beginning with the first date of the required amount of dividend arrearage and ending with the first date as of which both all arrearages were fully paid and the full dividend for the then current quarterly period was paid or declared and set apart for payment. Upon expiration of the Class Voting Period, the Class A preferred shareholders ceased to have the right to vote for directors and ceased to have their other general voting rights (i.e., their [REDACTED]% voting power respecting any other matter to be acted upon by shareholders). The term of office of all directors elected by Class A preferred shareholders during the Class Voting Period was to expire at the end of the Class Voting Period. If after the expiration of a Class Voting Period, the requisite amount of dividend arrearages occurred again, there would be another Class Voting Period and so on. 4/

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4/ There appears to be a discrepancy between the Agreement referred to earlier (which specified the terms of the recapitalization) and the statement of the Class A preferred stock's voting rights set forth in [REDACTED]'s amended charter. The Agreement implied that dividend arrearages would trigger the assumption by Class A preferred shareholders of voting rights respecting the election of directors (as well as respecting other general corporate matters) after [REDACTED]. The amended charter, on the other hand, provided that dividend arrearages would not result in a transfer of such voting rights to preferred shareholders until after [REDACTED]. Since this apparent discrepancy is not material to a resolution of the two questions we actually address in this memorandum--namely, whether the Class A preferred stock may be treated as voting stock for purposes of section 338(d)(3) and whether [REDACTED] is a target affiliate in a qualified stock purchase under section 338--we make no effort here to reconcile or evaluate the discrepancy. We note only that regardless of whether [REDACTED] or [REDACTED] was the threshold for the dividend arrearages-triggered transfer of voting rights to the Class A preferred shareholders, these (footnote 4 continued on next page)

In addition to the contingent voting rights described above, the amended charter of [REDACTED] granted holders of Class A preferred stock voting rights in connection with certain kinds of activity of [REDACTED]. These additional voting rights were not conditioned on dividend arrearages or on the passage of a certain date (such as [REDACTED]). Rather, they were exercisable from the moment of issuance of the preferred stock at any time [REDACTED] wished to engage in an activity covered by the rights.

Under these rights, [REDACTED] could not, without the affirmative vote or the written consent of the holders of at least [REDACTED] ( [REDACTED] ) of the Class A preferred stock: 5/

"(i) Create, authorize or issue any class or series of stock ranking either as to payment of dividends or distribution of assets prior to the Preferred Stock.

(ii) Change the preferences, rights or powers with respect to the Preferred Stock so as to affect such stock adversely.

(iii) Amend its Articles of Incorporation or Bylaws, except that the corporation may amend its Articles of Incorporation to create another class of non-voting preferred stock which is subordinate in all rights and preferences to the Preferred Stock.

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4/ shareholders had no right to vote for directors unless and until there were dividend arrearages. Furthermore, their right to vote for directors in the event of dividend arrearages was limited to the duration of the arrearages (plus the additional period, if any, preceding payment of or provision for payment of the then current quarterly dividend). Since the distinction between a [REDACTED] threshold and a [REDACTED] threshold is not material to our discussion here, since the Agreement's use of a [REDACTED] threshold was only implicit while the [REDACTED] threshold in [REDACTED]'s amended charter was explicit and since the amended charter probably preempted the Agreement on this point, we will consider [REDACTED] to be the threshold for purposes of our analysis here and will make no further reference to [REDACTED] as a possible threshold.

5/ The term "Preferred Stock" in the quote following this footnote refers to Class A preferred stock, the only class of preferred stock issued in the [REDACTED] recapitalization. The only recipient of Class A preferred stock in the recapitalization was [REDACTED].

(iv) Incur any new indebtedness for which there is recourse to the corporation or any indebtedness secured by any of its assets held on [REDACTED]; provided that the corporation may refinance any of its indebtedness outstanding on [REDACTED] on commercially reasonable terms;

(v) Incur aggregate liabilities in excess of the sum of (a) [REDACTED] (\$ [REDACTED]) and (b) net income of the corporation accumulated after [REDACTED] other than liabilities owed to [REDACTED].

(vi) Declare any dividend on, make any distribution with respect to or repurchase the Common Stock in an amount in excess of the net income of the corporation accumulated after [REDACTED].

(vii) Merge, consolidate, sell substantially all of its assets or enter into any similar transaction, provided that the foregoing limitation shall not affect the alienability of the Common Stock or the Preferred Stock by any holder thereof.

(viii) Pay any dividends on the Preferred Stock after [REDACTED] out of the assets of the corporation (or proceeds thereof) owned by the corporation on [REDACTED], except to the extent of net income of the corporation accumulated after [REDACTED].

(ix) Sell or transfer any assets of the corporation for an amount less than the fair market value of such assets."

The preceding discussion expounds the limited voting rights of Class A preferred stock. Except for these rights, the voting power of the capital stock of [REDACTED] was vested, after its [REDACTED] recapitalization, in the new common stock issued to [REDACTED]. 6/ The terms of [REDACTED]'s purchase of the new common stock were embodied in a "[REDACTED]" (the "Subscription Agreement") entered into by [REDACTED], [REDACTED] and [REDACTED] as of [REDACTED]. [REDACTED] stated purpose for entering into this agreement was to "induce [REDACTED] ... to subscribe for and purchase [REDACTED] shares of [REDACTED] Common Stock". 7/

6/ As stated earlier, the recapitalization of [REDACTED] involved not only the preferred stock/common stock exchange with [REDACTED] but also the issuance of new common stock to [REDACTED].

7/ See the Preamble to the Subscription Agreement.

In [REDACTED] of the Subscription Agreement, [REDACTED] indemnified [REDACTED] and [REDACTED] against and in respect of: (i) all losses, damages, liabilities and deficiencies arising directly or indirectly out of or in connection with any default (including the failure to pay rent) by any lessee of [REDACTED] equipment under its lease with [REDACTED] and (ii) all proceedings, demands, claims, assessments, judgments, costs and expenses (including legal and accounting expenses) incident to the matters indemnified in clause (i). This two-part indemnification was limited to the [REDACTED] equipment leases which were in existence as of the common stock issuance to [REDACTED] and was further subject to a limitation on amount. Under paragraph (d) of [REDACTED] of the Subscription Agreement, [REDACTED] aggregate liability for its indemnity obligations under the Subscription Agreement (as well as under other agreements pertaining to the recapitalization) was limited to \$[REDACTED]. 8/

Less than a month after the recapitalization, new directors and officers of [REDACTED] were elected. 9/ Notwithstanding this election, the day-to-day administration of the equipment leases of [REDACTED] continued to be performed by the same individuals who managed the leases prior to the recapitalization. This continuity in administration of the [REDACTED] lease portfolio was achieved by means of an "Administration Agreement" between [REDACTED], [REDACTED] and a new subsidiary of [REDACTED] called [REDACTED] (hereafter the latter corporation will be referred to as "[REDACTED]"). The officers and other personnel of [REDACTED] were the same individuals who staffed [REDACTED] prior to the recapitalization.

[REDACTED] was incorporated under the laws of Nevada on [REDACTED]. It was wholly owned by [REDACTED] and its charter empowered it to engage in any lawful business. In addition to performing its responsibilities under the Administration Agreement, [REDACTED] engaged in leasing transactions for its own account.

Under the Administration Agreement, which was dated as of [REDACTED], New [REDACTED] was empowered and obligated as the agent of [REDACTED] to: (i) perform "administrative services" with respect to the equipment and equipment leases of [REDACTED], (ii) collect rents paid pursuant to the equipment leases and distribute such rents to [REDACTED] (iii) maintain records and books of account with respect to the

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8/ Prior to [REDACTED], indemnity payments, if called for, were to be made by [REDACTED] directly to [REDACTED]. On and after [REDACTED], such payments were to be made, first, in the form of a set-off against the redemption price of the [REDACTED] preferred shares held by [REDACTED]. That is, with respect to any indemnity obligations of [REDACTED] arising on or after [REDACTED], such obligations were to be applied first to reduce the redemption price of [REDACTED] preferred stock and only to the extent they exceeded the total redemption price of this stock were they to be paid directly to [REDACTED].

9/ Presumably, the new directors were chosen by [REDACTED] in its capacity as sole common shareholder of [REDACTED]. The new officers were presumably chosen by the new directors.

management and operation of the equipment and equipment leases of [REDACTED] and make such records available to [REDACTED] for inspection, (iv) submit monthly reports of operations to [REDACTED] and (v) act as agent for receipt of service of process against [REDACTED] in connection with the purchase, ownership or leasing of [REDACTED]'s equipment. In return for the services just enumerated, [REDACTED] was to be compensated by [REDACTED] at the rate of \$ [REDACTED] every three months. 10/

The Administration Agreement was to continue in full force and effect until [REDACTED] or [REDACTED] gave the other at least [REDACTED] days' prior written notice of intention to terminate the Agreement, in which event the Agreement would terminate at the end of such [REDACTED]-day period or thereafter on a date specified in such notice. The Administration Agreement expressly prohibited [REDACTED] from making "any major management decisions" or authorizing or incurring any expenditure or commitment "outside of the ordinary course of the holding, conserving, collecting and distributing" of income for the benefit of [REDACTED], unless [REDACTED] had obtained [REDACTED]'s specific prior concurrence in writing. In the event [REDACTED] determined that certain "ministerial" action by it with respect to [REDACTED]'s equipment or equipment leases was in the best interests of [REDACTED], [REDACTED] was authorized to take such action after written notice to [REDACTED] unless it received written notice of objection to such action from [REDACTED] within ten days after such notice.

Less than [REDACTED] weeks after the recapitalization, [REDACTED] sold its entire beneficial interest in its [REDACTED] common stock (which stock represented [REDACTED] of the issued and outstanding common stock of [REDACTED] to [REDACTED] (" [REDACTED] "). 11/ Apparently, [REDACTED] and [REDACTED] were affiliated corporations that filed a consolidated federal income tax return. On [REDACTED], [REDACTED] sold all of the [REDACTED] common stock to [REDACTED], a corporation outside of the [REDACTED] affiliated group. The terms of the sale between [REDACTED] and [REDACTED] are not disclosed in the documentation provided us.

In addition to purchasing the [REDACTED] common stock, [REDACTED] purchased all of the [REDACTED] Class A preferred stock held by [REDACTED]. The purchase of the preferred stock also took place on [REDACTED]; [REDACTED]'s obligation to purchase the preferred stock was expressly conditioned on the consummation of its purchase of the [REDACTED] common stock. 12/ The initial purchase price paid by [REDACTED] for the preferred stock was \$ [REDACTED] (or \$ [REDACTED] per share). This sum was delivered to [REDACTED] on the closing date, i.e., on [REDACTED].

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10/ In the event of a payment period covering less than three months, the compensation to be paid was the portion of \$ [REDACTED] determined by prorating that amount over the three-month period.

11/ The terms of this sale are not disclosed in the documentation we have been provided.

12/ That is, [REDACTED]'s acquisition of the common stock was a condition precedent to its obligation to purchase the preferred stock.



In [REDACTED], [REDACTED] and [REDACTED] agreed to a downward adjustment of the purchase price. <sup>13/</sup> The downward adjustment was in the amount of \$[REDACTED]; it was accomplished by [REDACTED] paying this amount to [REDACTED]. <sup>14/</sup> At the times of the transactions described in this paragraph, [REDACTED] and [REDACTED] were presumably unrelated corporations.

#### DISCUSSION

You have requested technical advice with respect to the following questions: (1) Should the recapitalization of [REDACTED] be disregarded for tax purposes since it was tax-motivated and lacked a significant business purpose? (2) Was [REDACTED] a "target affiliate" of [REDACTED] for purposes of the application of section 338 to [REDACTED]'s purchase of all the outstanding stock of [REDACTED]? <sup>15/</sup> (3) Should the [REDACTED] preferred stock issued to [REDACTED] pursuant to the recapitalization be treated as voting stock for purposes of section 338(d)(3)? (4) Was [REDACTED] acting as an agent of [REDACTED] in connection with the sale of the common and preferred stock of [REDACTED] to [REDACTED]?

As we explained to Mr. Jay Levinson of your office, we are unable to address or answer questions (1) and (4) since we lack the data necessary for an evaluation of these questions. We have communicated to Mr. Levinson the nature of the additional data we need and he has requested this data from [REDACTED]. As soon as we receive the additional data (which relates chiefly to the economics of the recapitalization and the economics of the subsequent sales of the [REDACTED] common and preferred stock to [REDACTED]), we will analyze questions (1) and (4) and present our analysis to you in a sequential technical advice memorandum.

Questions (2) and (3) are amenable to analysis with the data we have on hand. With regard to question (2), we conclude, for the reasons stated below, that [REDACTED] was a target affiliate of [REDACTED] in connection with [REDACTED]'s purchase of the stock of [REDACTED]. Section 338(h)(6) defines the term "target affiliate;" this provision

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<sup>13/</sup> The purchase price reduction was necessitated by [REDACTED]'s lack of entitlement to some of the tax benefits which [REDACTED] had warranted would flow from [REDACTED]'s purchase of [REDACTED].

<sup>14/</sup> The payment by [REDACTED] to [REDACTED] was to be made no later than [REDACTED].

<sup>15/</sup> Though stated separately here, questions (1) and (2) were consolidated as a single issue in your memorandum of March 9, 1987 requesting our advice. We reiterated the consolidated version of these questions in our recitation of the issues at the beginning of this technical advice memorandum (see the first issue listed under the ISSUES heading of this memorandum). Since, however, the resolution of question (2) does not depend on the resolution of question (1) -- i.e., the two questions are unrelated -- and since, as we explain more fully hereafter, we are unable to resolve question (1), we think it best to state and consider the questions separately.

specifies that a corporation, except for a foreign or certain other kind of corporation (none of the excepted categories applies to [REDACTED]), shall be treated as a target affiliate of a "target corporation" if both such corporations were, at any time during so much of the "consistency period" as ends on the "acquisition date" of the target corporation, members of the same "affiliated group". A target corporation is defined in section 338(d)(2) to be any corporation whose stock is acquired by another corporation in a "qualified stock purchase". Since [REDACTED] made a qualified stock purchase (as this term is defined in section 338(d)(3)) of the stock of [REDACTED], [REDACTED] was a target corporation for purposes of the definition of target affiliate. Hence, [REDACTED] was a target affiliate of [REDACTED] provided [REDACTED] and [REDACTED] were members of the same affiliated group at any time during so much of the consistency period as ended on the acquisition date of [REDACTED].

The term "acquisition date" is defined in section 338(h)(2) to be the first day on which there is a qualified stock purchase of a target corporation. In the case of [REDACTED], the acquisition date was [REDACTED], the date on which [REDACTED] purchased all of the stock of [REDACTED]. Hence, the ending point of the measuring period for determining whether a corporation was a target affiliate of [REDACTED] was [REDACTED].

The beginning point of this measuring period was the commencement date of the consistency period applicable to [REDACTED]'s qualified stock purchase of [REDACTED]. The term "consistency period" is defined in section 338(h)(4) to mean the period consisting of (i) the [REDACTED]-year period before the beginning of the "[REDACTED]-month acquisition period" for the target corporation, (ii) such acquisition period up to and including the acquisition date, and (iii) the 1-year period beginning on the day after the acquisition date. The "[REDACTED]-month acquisition period" refers to the [REDACTED]-month period beginning with the date of the first acquisition by purchase of stock included in a qualified stock purchase. In the case of [REDACTED]'s purchase of [REDACTED] stock, the [REDACTED]-month acquisition period began on [REDACTED], the first and only date on which [REDACTED] purchased [REDACTED] stock.

Accordingly, the consistency period for the [REDACTED] qualified stock purchase of [REDACTED] began one year prior to [REDACTED], the latter date being the beginning date for the [REDACTED]-month acquisition period for [REDACTED]. Since the consistency period for the qualified stock purchase of [REDACTED] began on [REDACTED] and continued to (and beyond) the acquisition date of [REDACTED], which was [REDACTED], [REDACTED] was a target affiliate of [REDACTED] provided [REDACTED] and [REDACTED] were members of the same affiliated group at any time during the period beginning on [REDACTED] (the commencement date of the consistency period) and ending on [REDACTED] (the acquisition date of [REDACTED]).

The proviso just stated is clearly satisfied by the facts here. [REDACTED] and [REDACTED] were members of the same affiliated group in [REDACTED], by virtue of [REDACTED] ownership at that time of all the

outstanding capital stock of [REDACTED] 16/ Their status as affiliated corporations continued to [REDACTED], the date [REDACTED] exchanged its [REDACTED] common stock for [REDACTED] preferred stock. Hence, since [REDACTED] and [REDACTED] were affiliated corporations at a time during the [REDACTED] - [REDACTED] measuring period, [REDACTED] was a target affiliate of [REDACTED] in connection with the [REDACTED] qualified stock purchase of [REDACTED].

[REDACTED]'s status as a target affiliate of [REDACTED] would trigger tax consequences under section 338, i.e., tax consequences arising from a deemed sale of [REDACTED]'s assets, only in the event [REDACTED]'s capital stock was the subject of a qualified stock purchase, either actual or deemed, by [REDACTED] or an affiliate of [REDACTED] (including [REDACTED]) during the consistency period. Absent such a qualified stock purchase of [REDACTED] stock, [REDACTED]'s target affiliate status would not result in a deemed sale of its assets. If, however, such a qualified stock purchase occurred, [REDACTED]'s status as a target affiliate, by virtue of the consistency rules of section 338(f), would cause a deemed election of section 338 to be made with respect to the [REDACTED] qualified stock purchase. The deemed election in turn would result in a deemed sale of [REDACTED]'s assets with the attendant tax consequences.

The pivotal role of a qualified stock purchase is underscored by question (3). It asks whether the [REDACTED] preferred stock issued to [REDACTED] pursuant to the recapitalization should be treated as voting stock for purposes of section 338(d)(3). Section 338(d)(3) defines what constitutes a qualified stock purchase. Under this provision, a qualified stock purchase is any transaction or series of transactions in which stock of 1 corporation possessing (i) at least [REDACTED] percent of the total combined voting power of all classes of stock entitled to vote and (ii) at least [REDACTED] percent of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends), is acquired by another corporation by purchase during the [REDACTED]-month acquisition period. If the [REDACTED] preferred stock issued to [REDACTED] constituted voting stock for purposes of this provision, [REDACTED] arguably would be deemed to have made a qualified stock purchase of [REDACTED] on [REDACTED] [REDACTED], the date of [REDACTED]'s qualified stock purchase of [REDACTED] 17/

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16/ The term "affiliated group" as used in the section 338 definition of target affiliate has the meaning given such term by section 1504(a) (determined without regard to the exceptions contained in section 1504(b)). See section 338(h)(5) for the cross-reference to section 1504.

17/ By virtue of [REDACTED]'s election of section 338 with respect to its qualified stock purchase of [REDACTED], [REDACTED] was deemed to have purchased on [REDACTED] all of its own assets, including the [REDACTED] preferred stock. This deemed purchase by [REDACTED] of the [REDACTED] preferred stock would arguably constitute a qualified stock purchase of [REDACTED] if the preferred stock was treated as voting stock. If the deemed purchase was treated as a qualified stock purchase, the consistency rules of section 338(f) would apply to cause a deemed election of section 338 with respect to the deemed qualified stock purchase of [REDACTED].

For the reasons stated below, we conclude that the [REDACTED] preferred stock should not be treated as voting stock for purposes of section 338(d)(3) and, therefore, that [REDACTED] deemed purchase of the preferred stock should not be considered a qualified stock purchase of [REDACTED]. Section 338, if elected (or deemed to be elected), operates to treat a qualified stock purchase as an asset acquisition. An actual asset acquisition involves obtaining physical possession of the assets acquired and the exercise of direct control over the operation and management of these assets. By limiting its asset acquisition treatment to qualified stock purchases, i.e., to purchases of stock possessing at least [REDACTED]% voting control and, roughly speaking, [REDACTED]% of the value of the acquired corporation, section 338 ensures that asset acquisition treatment will be accorded only to those stock purchases which have the economic substance and practical effects of an actual asset acquisition. The requirement of [REDACTED]% voting control ensures, for example, that the purchasing corporation will have the right to manage and supervise the operation and ultimate disposition of the assets of the acquired corporation and, if it so desires, to obtain physical possession of these assets by liquidating the acquired corporation. <sup>18/</sup> The control over the assets of the acquired corporation represented by [REDACTED]% voting control is exercised on a day-to-day basis by means of the stock's right to elect directors. It is the directors who actually supervise the daily use and disposition of the corporation's assets.

The limited voting rights of the [REDACTED] preferred stock issued to [REDACTED] did not afford the type of voting power contemplated by section 338(d)(3). The voting power (and the required magnitude of it) contemplated by this provision underlies the core concept of section 338, namely, that certain stock purchases are in substance the economic and functional equivalents of asset acquisitions. The voting rights of the [REDACTED] preferred stock were qualitatively deficient in respect of this core concept for several reasons. First, for the first five years after the recapitalization and thereafter absent dividend arrearages equal to two or more full quarterly dividends, the preferred stock afforded its holders no right to elect directors. Hence, the day-to-day management and control of the assets of [REDACTED] was vested entirely in corporate officers chosen by directors elected exclusively by holders of [REDACTED] common stock. These officers and directors could, without any right on the part of preferred shareholders to object, sell the assets of [REDACTED] provided they received market value for them and provided further that the sales did not amount to a sale of substantially all of the assets of [REDACTED]. Second, holders of preferred stock had no right to obtain physical possession of [REDACTED] assets by compelling a liquidation of [REDACTED] and, even with respect to their redemption rights, these were not operative until five years

<sup>18/</sup> In effect, section 338 eliminates the formalism of requiring an actual liquidation to obtain asset acquisition treatment.

after the recapitalization. Third, absent dividend arrearages and except for their right to cause a redemption of their stock after five years, holders of preferred stock had no affirmative rights to compel [REDACTED] to make a particular use or uses of its assets. Other than their contingent voting rights arising from dividend arrearages, the only voting rights they had were in the nature of a veto power over certain kinds of activity of [REDACTED]. This veto power was designed principally to protect the equity investment of preferred shareholders; it was not intended to vest them with daily management and control of [REDACTED]'s business and assets.

Our view that the [REDACTED] preferred stock was not voting stock for purposes of section 338(d)(3), i.e., that its voting rights were not of the type contemplated by that provision, receives support in the case law and our own published revenue rulings. <sup>19/</sup> Specifically, we cite and rely here on several legal precedents involving the meaning of voting stock for purposes of section 1504 (or its statutory predecessors), the provision defining what constitutes an affiliated group. We note that section 338 incorporates the section 1504 definition of affiliated group (including its concept of voting stock) for purposes of applying the term "affiliated group" to the definition of target affiliate.

Section 1504(a) generally provides that an affiliated group consists of one or more chains of "includible corporations" connected through stock ownership with a common parent company which is an includible corporation. The common parent must own directly at least [REDACTED]% of the combined voting power of all classes of stock and at least [REDACTED]% of each class of nonvoting stock, of one or more includible corporations. For purposes of the section the term "stock" does not include nonvoting stock which is limited and preferred as to dividends.

In Vermont Hydro-Electric Corp.v. Commissioner, 29 BTA 1006 (1934), acq. XIII-1 C.B. 16, holders of preferred shares were not entitled to vote unless there was a default in the payment of four quarterly dividends existing at any one time on any of the preferred stock issued and outstanding. The court held, in essence, that the facts actually existing with respect to stock during a taxable year are controlling as to whether it is voting stock rather than the possibility that under certain circumstances nonexistent during such period the stock might become voting stock.

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<sup>19/</sup> There is no case law or published ruling addressing the issue of what constitutes voting stock for purposes of section 338(d)(3). All cases and published rulings addressing the issue of what constitutes voting stock do so in the context of some other Code provision, such as section 1504 or 368(c).

See also Erie Lighting Co. v. Commissioner, 93 F.2d 883 (1st Cir. 1937) (where holders of preferred stock had right to vote in regard to increase of capital stock, any increase of the capital indebtedness, any reduction of the capital stock and other matters, but had no power to vote at election for directors unless dividend on preferred stock was in arrears for two quarterly periods and where during taxable periods conditions giving right to participate in election of directors had not arisen, the preferred stock was nonvoting stock for purposes of determining whether grounds for affiliation existed).

In the case of Rudolph Wurlitzer Co. v. Commissioner, 29 B.T.A. 443 (1933), affirmed, 81 F.2d 971 (1936), certiorari denied, 298 U.S. 676 (1936), it was held that where, by State law, the holders of preferred stock had the privilege of voting for directors (but no other voting rights), the stock was voting stock within the meaning of the predecessor of section 1504(a) of the Code.

Rev. Rul. 69-126, 1969-1 C.B. 218, provides that a parent corporation which holds both common and preferred stock in a subsidiary corporation and possesses at least 80 percent of the aggregated voting power of all classes of stock may file a consolidated return. Owning 100 percent of the common stock and 50 percent of the preferred stock, it can elect board members with voting stock constituting 81.25 percent of the voting power of all classes of stock. In this instance the common stockholders vote for five of the eight directors on the board, the preferred stockholders for the remaining three. Consequently, the parent has 62.5 percent of the board voting power (five of eight) from ownership of its common stock and 18.75 percent of the board voting power (50 percent of three of eight) from its half of the preferred stock. Therefore, for purposes of section 1504(a), it has 81.25 (62.5 plus 18.75) percent of the aggregate voting power of all classes of voting stock.

Rev. Rul. 71-83, 1971-1 C.B. 268 involved holders of convertible preferred stock which have a cumulative preference to dividends at a designated annual rate but have no voting rights except with respect to certain changes in the articles of incorporation or the corporation's right to create additional stock that is senior to or on parity with the preferred stock. The ruling holds, in part, that the nonvoting cumulative preferred stock does not constitute stock for purposes of section 1504(a). The holding was based on the rationale that in determining the voting power of all classes of stock entitled to vote under section 1504, actual voting power existing at the time the test is required to be made is to be considered without regard to the convertibility of nonvoting stock into voting stock.

The above authorities evoke two observations: stock voting rights are often equated with the right to elect directors and stock voting rights are to be measured in terms of existing, rather than potential, voting rights. To state the latter proposition differently, contingent voting rights that have not materialized are to be ignored in determining whether stock is voting stock. Applying these principles to the [REDACTED] preferred stock, we note first that its voting rights, for purposes of determining whether they qualify as voting rights under section 338(d)(3), are to be measured as of the time of [REDACTED] deemed purchase of the [REDACTED] preferred stock, i.e., as of [REDACTED]. At that time, [REDACTED] preferred stock afforded its holders no right to vote for directors; their rights respecting the election of directors were contingent on future dividend arrearages and as such were to be ignored. The same is true of the other contingent voting rights of [REDACTED] preferred stock not materialized as of that time. Thus, as of [REDACTED], the only voting rights of [REDACTED] preferred stock to be weighed were the "veto" rights respecting certain kinds of activity of [REDACTED]. These limited rights were clearly not what section 338(d)(3) had in mind in imposing a voting stock requirement. In sum, the [REDACTED] preferred stock as of [REDACTED], was not voting stock for purposes of section 338(d)(3).

#### CONCLUSIONS

[REDACTED] was a target affiliate of [REDACTED] in connection with a qualified stock purchase of [REDACTED] stock. The [REDACTED] preferred stock issued to [REDACTED] pursuant to the recapitalization of [REDACTED] was not voting stock for purposes of section 338(d)(3). Conclusions with respect to the other issues enumerated above are deferred to a future technical advice memorandum, to be written and forwarded to you after our receipt of the additional data we have requested.

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